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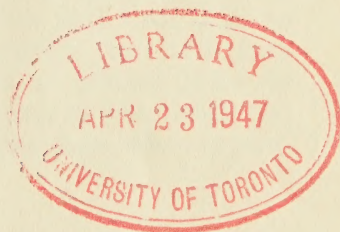
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ANSWERS TO SOME QUESTIONS

ABOUT THE

UNOFFICIAL MARKET IN CANADIAN DOLLARS

FOREIGN EXCHANGE CONTROL BOARD
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THE UNOFFICIAL MARKET IN CANADIAN DOLLARS

From time to time Canadians have noted the existence of an unofficial market for Canadian funds in New York. Many Canadians and others who are aware of this unofficial market have not known how or why it arises. They have noticed that Canadian dollars are sometimes priced on this market at less than the official rate and may have felt that this reflects the worth of the Canadian dollar in the judgment of non-residents. Other misconceptions have also arisen from unfamiliarity with the circumstances.

Because the circumstances involved in the unofficial market in Canadian dollars are not widely known, the present brochure is designed to provide answers to the questions most frequently asked about it.

Key Facts About the Unofficial Market

Before considering the questions, these general facts should be considered.

1. All exchange transactions in Canada take place through official channels and at official rates of exchange. The unofficial market in Canadian dollars (in which the Canadian dollar has on occasion been quoted at less than the official rate) is entirely located outside of Canada.

2. Transactions in this market are invariably between two non-residents. No resident of Canada is ever authorized to acquire foreign exchange through the unofficial market and no resident of Canada coming into possession of foreign exchange is ever authorized to convert it into Canadian dollars through the unofficial market.

3. The market arises because capital transfers to non-residents are permitted relatively freely under Canadian foreign exchange control regulations. Before noting the sources of Canadian funds that find their way to the unofficial market, it is well to remember that residents of Canada can obtain foreign exchange at official rates to meet not only all current account items due to non-residents, such as payment for goods and services, but also capital

obligations expressed in foreign currency, such as maturing bond issues, as they fall due, and in some cases in advance of the date on which they fall due.

But in addition to these types of transaction, Canadian regulations also enable many other types of capital payments to non-residents to be made in Canadian dollars but *without the privilege of conversion into other currencies in Canada*. Canadian dollars paid in this way to non-residents are not "blocked" and may be transferred between one non-resident holder and another. Such a transaction would make it possible, for instance, for one American receiving Canadian dollars through the sale of real estate in Canada to obtain U.S. dollars by selling the Canadian dollars to another American. Thus there exists a supply of Canadian dollars in the hands of non-residents which are not convertible into U.S. dollars at the official rate in Canada but which the non-residents are free to transfer among themselves. This supply creates and maintains the unofficial market in the United States. These dollars will be referred to throughout this brochure as "inconvertible" Canadian dollars.

4. The use which can be made of Canadian dollars acquired by a non-resident in this way is limited by Canadian exchange control regulations. In particular, these regulations require Canadians to obtain foreign exchange for all commercial exports to the United States and for commercial services, etc. Canadian dollars cannot be accepted in payment for these things. For this reason, the most important use for Canadian dollars acquired by non-residents in the unofficial market is to make a capital investment in Canada—for example, to purchase Canadian securities, or to make loans, or to invest in Canadian businesses. When the capital withdrawn by one non-resident in the form of "inconvertible" Canadian dollars is acquired by another non-resident in the unofficial market for the purpose of making a capital investment in Canada, it is clear that no net export of capital from Canada takes place.

5. The only important exception to the rule that residents of Canada must receive foreign exchange in return for exports of goods or services to the United States is the case of tourists temporarily in Canada. For practical reasons these tourists may use Canadian dollars in payment for services rendered to them.

6. Canadian dollars acquired in the unofficial market are thus "limited purpose" dollars. They can only be used for certain types of payment in Canada. Their price is naturally affected by the restriction of their possible use and depends upon the demand for Canadian dollars for those particular purposes in relation to the supply of "inconvertible" Canadian dollars available. A dollar that can only be used in certain ways is obviously likely to be quoted at a discount below a dollar that has unlimited application.

7. The amount of Canadian dollars changing hands on the unofficial market is small. The volume of transactions in this market has not run to more than a small fraction of Canada's international transactions.

Answers to Questions

It can be seen from these facts that the unofficial rate for Canadian dollars does not necessarily reflect the judgment of non-residents as to the value of Canadian funds in general, but reflects rather the limited use that can be made of Canadian funds obtained in this way. But various questions on this subject arise to which the following answers are provided.

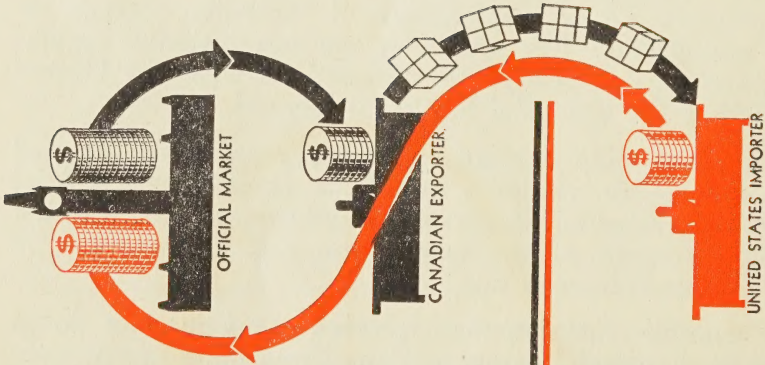
What Controls are Maintained in Canada on Outgoing Foreign Exchange?

A full understanding of the unofficial market in Canadian funds requires a brief explanation of Canadian foreign exchange regulations. For simplicity the description of regulations given here is related to transactions with the United States where the unofficial market is located.

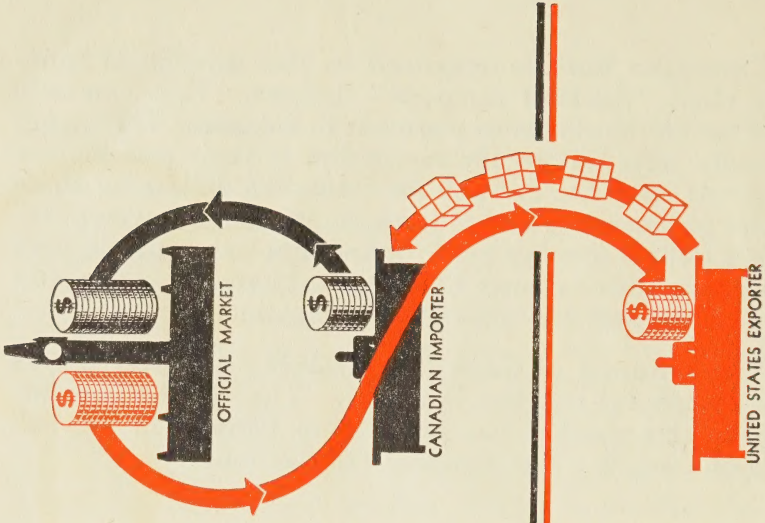
Under Canadian foreign exchange regulations, United States dollars are available at official rates out of official Canadian reserves for *all current account transactions*, whether the original terms of the transaction call for payment in United States dollars or not.

For example, an American receiving a Canadian dollar interest or dividend cheque, or Canadian dollars in payment for a shipment of goods to Canada, can send the record of payment to a Canadian bank with instructions to convert

CURRENT TRANSACTIONS



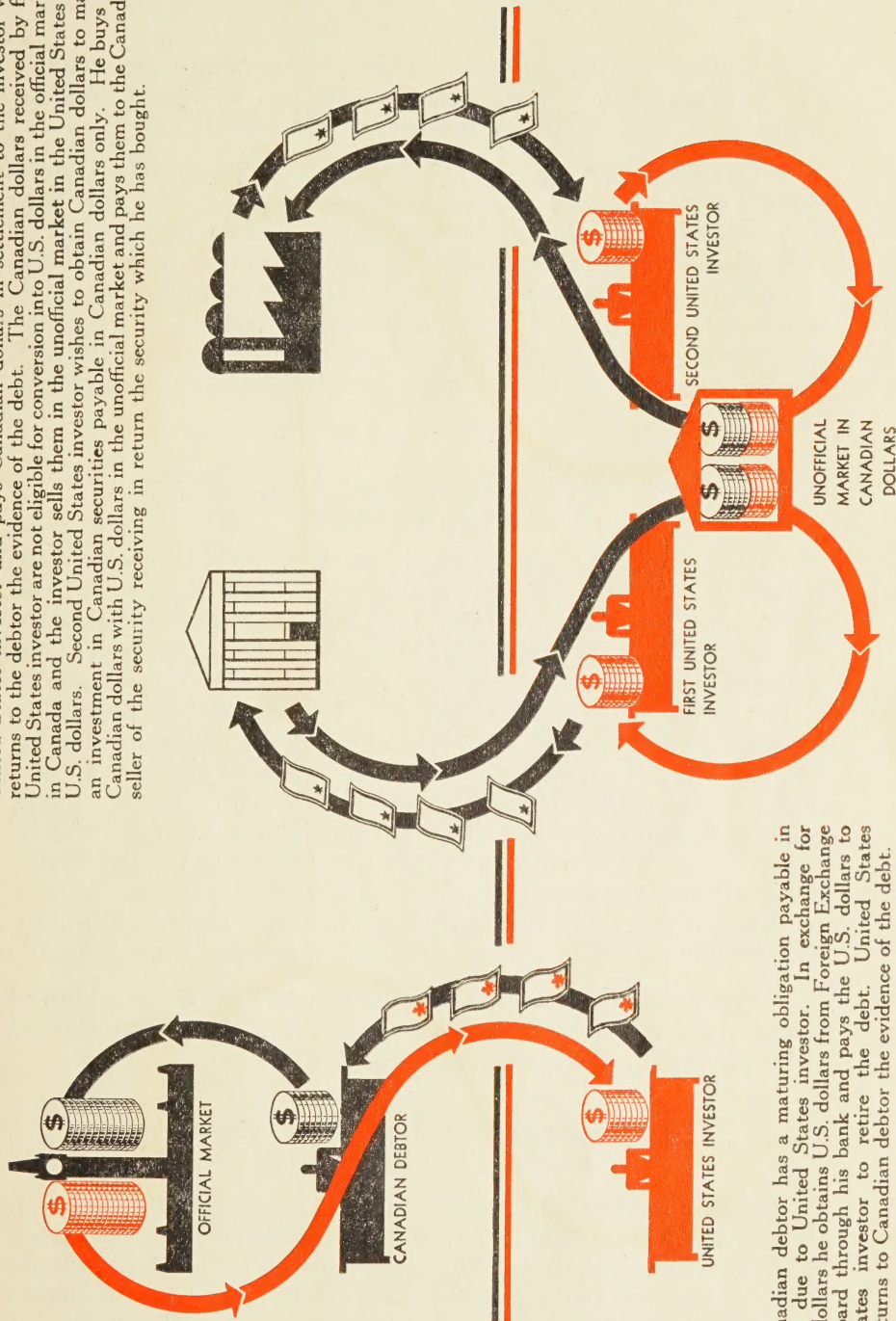
1. Canadian exporter ships goods to United States importer and obtains payment from him in U.S. dollars. The U.S. dollars are turned over to Foreign Exchange Control Board through the Canadian exporter's bank in exchange for Canadian dollars.



2. Canadian importer receives a shipment of goods from United States exporter. In exchange for Canadian dollars he obtains U.S. dollars from Foreign Exchange Control Board through his bank and sends the U.S. dollars to United States exporter in payment for the goods.

CAPITAL TRANSACTIONS

4. Canadian debtor has a maturing obligation payable in Canadian funds due to first United States investor and pays Canadian dollars in settlement to the investor who returns to the debtor the evidence of the debt. The Canadian dollars received by first United States investor are not eligible for conversion into U.S. dollars in the official market in Canada and the investor sells them in the unofficial market in the United States for U.S. dollars. Second United States investor wishes to obtain Canadian dollars to make an investment in Canadian securities payable in Canadian dollars only. He buys the Canadian dollars with U.S. dollars in the unofficial market and pays them to the Canadian seller of the security receiving in return the security which he has bought.



3. Canadian debtor has a maturing obligation payable in U.S. funds due to United States investor. In exchange for Canadian dollars he obtains U.S. dollars from Foreign Exchange Control Board through his bank and pays the U.S. dollars to United States investor to retire the debt. United States investor returns to Canadian debtor the evidence of the debt.

into United States dollars. These conversions are readily effected and funds are provided out of official Canadian reserves of United States dollars at the official rate.

In addition to all such current account payments, *certain capital payments* may also be made by residents of Canada to non-residents in United States dollars at official rates. For example, United States dollars are provided from official Canadian reserves to pay off maturing debts, including bond issues, which are payable in United States funds. The present policy also permits such payments to be made before they are legally due through the calling of such obligations in advance of maturity.

What General Regulations Cover Incoming Foreign Exchange?

With reference to receipts, residents of Canada are required to collect foreign exchange for exports and to sell these foreign funds to a bank in Canada or otherwise account for them to the Foreign Exchange Control Board, except for occasional exports involving not more than \$100 in Canadian funds. Residents are also required to follow a similar procedure in obtaining payment for services rendered to residents of the United States, except in the case of professional services and services performed in Canada for tourists. In the latter case, a requirement to collect United States funds would be quite impossible to enforce. Residents receiving United States dollars from investments in the United States, either as income or through the sale of securities, etc., must also account for the foreign exchange to the Foreign Exchange Control Board.

Canadians are not, of course, permitted to convert United States dollars received from any source into Canadian dollars through the unofficial exchange market.

Where Does the Unofficial Market Obtain Its Supply of Canadian Dollars?

From the preceding description, it is clear that Canadian dollars which find their way into the unofficial market consist entirely of capital items, since all current account payments due to non-residents can be converted into United States dollars out of official Canadian reserves at the official rate.

A basic supply of "inconvertible" Canadian dollars consists of bank balances held by non-residents in Canada at the time when foreign exchange control was introduced in September, 1939. At the present time these bank balances cannot be converted into U.S. funds out of official reserves in Canada, but they can be transferred freely between one non-resident and another in the unofficial market. It has been the aim of Canadian exchange policy to avoid anything in the nature of "blocked accounts" which would prevent the transfer of Canadian dollar balances from one non-resident to another.

Other supplies of Canadian dollars find their way to the unofficial market through new capital transactions permitted in "inconvertible" Canadian dollars. These consist, for the most part, of sales by Americans of various kinds of capital assets in Canada. For example, some Americans bought Canadian securities for cash since 1940 and registered their purchases with the Foreign Exchange Control Board at the time of purchase. Under the rules in force, these Americans have been authorized to sell those securities in Canada and to transfer the Canadian dollar funds obtained in this way to other Americans. Similarly, Americans have been authorized to sell real estate and receive the proceeds in "inconvertible" Canadian dollars. Finally, proceeds from maturing securities payable solely in Canadian dollars are transferred to non-residents in "inconvertible" funds.

It is through these types of transaction that the unofficial market obtains its supply of Canadian funds.

Who Buys Canadian Funds Through the Unofficial Market?

The demand for Canadian funds through the unofficial market arises mainly from the use which can be made of Canadian dollars so obtained for capital investment in Canada.

For example, Americans who wish to buy Canadian securities, or to purchase real estate in Canada, or to make loans or investments in Canada, can buy Canadian funds on the unofficial market for this purpose.

Other Americans intending to travel in Canada occasionally buy Canadian funds in the unofficial market.

Why are Canadian Dollars Frequently Quoted in the Unofficial Market at a Discount below the Official Rate?

The rate quoted for the Canadian dollar in the unofficial market in the United States depends upon supply and demand conditions in a narrow and highly specialized market. The supply consists of capital items in the hands of non-residents which they are unable to convert into U.S. funds at the official rate. The demand is mainly for capital investment in Canada by non-residents. If at any time the supply exceeds the demand in this market, a discount will naturally arise. This discount really represents an inducement offered by one non-resident to another to take over a capital investment in Canada which cannot be converted into U.S. funds through official channels at the official rate.

So far as Canadian banknotes and coin are concerned, it has unfortunately always been the case that merchants, hotel-keepers, and even many banks in the United States have been reluctant to handle them and if they are ready to accept them at all, charge a discount which has little relation even to the rate quoted in New York for cheques, bank drafts, etc. To a small extent there is some justification for this since if there is no local demand for the currency it has eventually to be shipped to a bank in a large centre in the United States or in Canada with consequent expense for express charges, insurance and so on. It should be kept in mind that no Canadian should be under the necessity of accepting this discount as United States funds for reasonable travel expenditures can be obtained at the official rate in Canada.

Is the Discount Quoted on the Unofficial Market Really a Subsidy on Canadian Exports?

The idea that Canadian dollars acquired in the unofficial market at a discount by Americans could be used by them to pay for exports from Canada, thus constituting in effect a subsidy on these exports, is incorrect. Canadian exporters must always obtain payment in U.S. funds which they are obliged to sell to a bank in Canada at the official rate. Thus the discount quoted on the unofficial market is unavailable to foreign purchasers of Canadian goods.

Does Canada Convert the Proceeds of Gold Exports into Canadian Funds in the Unofficial Market ?

It has sometimes been said that when the Canadian Government sells gold abroad it converts the U.S. funds it receives into Canadian dollars through the unofficial market, thus obtaining a premium which is not passed on to the gold producers. This is not the case. The U.S. dollars realized from sales of gold abroad by the Canadian Government or the Bank of Canada are converted into Canadian dollars at the official rate of exchange and not through the unofficial market. The Canadian Government derives no financial benefit from the discount on Canadian dollars in the unofficial market. If the U.S. dollar proceeds of gold or any other export were converted into Canadian dollars through the unofficial market, they would be in reality paid over to a non-resident wishing to withdraw his capital from Canada. But because these U.S. dollar proceeds are converted into Canadian dollars at the official rate in Canada, they enter Canada's official reserves and are available to finance imports and other payments abroad.

Why does the Canadian Government not Eliminate the Discount on the Canadian Dollar in the Unofficial Market ?

It would be possible to maintain a fixed rate for Canadian dollars in the United States only if the Canadian Government were prepared to buy at that rate any Canadian dollars which might be offered for sale there. This would involve a drain on Canada's U.S. dollar resources. In view of the fact that the funds entering the market for Canadian dollars in the United States consist entirely of liquidations of Canadian capital by non-residents, such a drain of U.S. dollars is regarded as an unnecessary one for Canada to undergo.

